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Cases, Regulations, and Statutes

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CASES, REGULATIONS AND STATUTES

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BANKRUPTCY

GENERAL

EXEMPTIONS.

TOOLS OF THE TRADE. The debtor filed for Chapter 7 and claimed a tools of the trade exemption for four horses and four one-year old heifers. The debtor claimed that the horses were used to give riding lessons and the heifers were used to teach rodeo roping and penning. The trustee objected to the exemptions because, under a Missouri case, *In re Eakes, 69 B.R. 497 (Bankr. W.D. Mo. 1987)*, animals were not included as tools of a trade because Missouri law provided separate exemptions for animals and tools of a trade. The court, however, allowed the exemptions in this case because the horses and cattle were necessary implements for the performance of the debtor's business. ***In re* Gray, 303 B.R. 632 (Bankr. W.D. Mo. 2003)**.

FEDERAL TAX

DISCHARGE. The debtor filed for Chapter 7 and all but $6,000 of the claims were unpaid federal income taxes. The debtor failed to timely file income tax returns for most of the years between 1988 and 2000 and paid only $21,000 of the more than $400,000 in taxes owed. The debtor also failed to make employment tax payments for the debtor's business and to make quarterly estimated tax payments while self-employed. During these years, the debtor had sufficient income to pay the taxes and incurred substantial luxury expenses, including luxury cars, frequent vacations, gardeners and private schooling for the debtor's children. The court noted that, even when the debtor reduced expenses, the taxes were not paid. In addition, the debtor placed many of the debtor's assets and leases in someone else's name, indicating an attempt to hide these transactions from the IRS. The court held that the debtor's conduct indicated that the debtor made a conscious and deliberate decision not to pay the taxes which constituted a willful attempt to evade payment of the taxes, making the taxes nondischargeable. ***In re* Epstein, 303 B.R. 280 (Bankr. E.D. N.Y. 2004)**.

ENVIRONMENTAL LAW

CERCLA. The plaintiffs were environmental organizations which charged that the defendant failed to comply with the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675, by not reporting the ammonia emissions from the defendant's confinement poultry operations. The court held that the poultry houses were facilities governed by CERCLA. The defendant also argued that the facilities were exempt from the reporting requirements. The court noted that CERCLA requires an owner of a facility to report emissions as continuous and stable to be eligible for reduced reporting requirements and, if the owner has insufficient information about the emissions, a report must still be made of the emissions over a period of time sufficient to determine the nature of the emissions. Because the defendant made no reports, the court held that the defendant had not qualified for any reduced reporting requirements. The defendant also argued that the chicken operations were "routine agricultural operations" eligible for an exemption from emission reporting. The court held that the exemption applied only to agricultural inputs such as fertilizer and manure which is applied in the farming operation; whereas, the ammonia produced in the poultry houses was a waste material which was disposed of in the air. **Sierra Club, Inc. v. Tyson Foods, Inc., 299 F. Supp.2d 693 (W.D. Ky. 2003)**.

FEDERAL AGRICULTURAL PROGRAMS

ORGANIC FOODS. The plaintiff challenged 7 C.F.R. § 205.207 as failing to properly implement a provision of the Federal Organic Foods Production Act of 1990. 7 U.S.C. § 6513(f)(4) provides that an organic plan for the harvesting of wild crops must include, among other things, "provisions that no prohibited substances will be applied by the producer." The plaintiff claimed that Section 205.207 failed to implement the statute for harvesting of wild crops because the section does not prohibit rotation of wild crops in and out of organic status. The court noted that the regulation cited by the plaintiff does not address organic plans, but only provides the standards for wild crop harvesting. Instead, the court noted, the regulation dealing with the content of organic plans is 7 C.F.R. § 205.201, which provides, in part, that an organic production plan for agricultural products must contain "[a] description of the management practices and physical barriers established . . . to prevent contact of organic production and handling operations and products with prohibited substances." The court held that, by requiring that organic plans contain assurances that prohibited substances will not be applied, 7 C.F.R. § 205.201 implements section 6513(f)(4) of the statute. Therefore, the court held that the plaintiff's challenge was improper and granted summary judgment for the USDA. **Harvey v. Veneman, 297 F. Supp.2d 334 (D. Me. 2004).**

TREE ASSISTANCE PROGRAM. The FSA has announced the availability of $5,000,000 to provide assistance under the Tree Assistance Program to compensate tree-fruit growers in a federally-declared disaster area in the state of New York who suffered tree losses in 2003 as the result of an April 4-6, 2003, ice storm. The area includes the counties of Cayuga, Chenango, Livingston, Madison, Monroe, Oneida, Onondaga, Ontario, Orleans, Oswego, Otsego, Schenectady, Seneca, Wayne, and Yates. Applications by eligible persons may be submitted any time before May 14, 2004, unless the date is adjusted by the Deputy Administrator. **69 Fed. Reg. 20589 (April 16, 2004)**.

FEDERAL ESTATE AND GIFT TAXATION

POWER OF APPOINTMENT. The decedent owned an interest in a trust in which the decedent had the right to appoint the decedent's interest in the trust principal to anyone. The decedent's will exercised this power through residuary estate bequests. The decedent and other trust beneficiaries had agreed that annual distributions from the trust could only be made if all beneficiaries requested distributions. The court held that the decedent's interest in the trust principal was included in the decedent's gross estate because the decedent held a general power of appointment over the decedent's interest in the trust. The court noted that the beneficiary agreement did not change the decedent's interest in the trust principal nor the decedent's power to appoint the interest. **Estate of Greve v. Comm'r, T.C. Memo. 2004-91**.

VALUATION OF STOCK. The taxpayers owned stock in a family closely-held food distributing corporation. The taxpayers transferred shares to trusts for their children. The stock was valued by giving 70 percent weight to the market approach and 30 percent weight to the income approach. The stock was then allowed a 40 percent discount for lack of marketability and 5 percent discount for lack of voting rights in one tax year. Because some business risks increased in later years, the lack of marketability discount was increased to 45 percent. **Okerlund v. United States, 2004-1 U.S. Tax Cas. (CCH) ¶ 60481 (Fed. Cir. 2004), *aff'g*, 2002-2 U.S. Tax Cas. (CCH) ¶ 60,447 (Fed. Cls. 2002)**.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued a revenue procedure which permits certain owners of royalty interests using the cash receipts and disbursements method of accounting to claim the credit for producing fuel from a nonconventional source under I.R.C. § 29 in the taxable year (including a 2003 taxable year) in which they receive the income from the sale of qualified fuel, rather than in a prior taxable year in which the owner of the operating interest sold the qualified fuel. **Rev. Proc. 2004-27, I.R.B. 2004-17**.

ALTERNATIVE MINIMUM TAX. The taxpayer's 2000 income tax return reported zero taxable income after itemized deductions and personal exemptions. The taxpayer's adjusted gross income was $46,834.16. However, the IRS assessed a deficiency based on alternative minimum tax. The taxpayer did not disagree with the IRS calculations of AMT but objected to imposition of the tax because the taxpayer did not have a high adjusted gross income. The taxpayer argued that Congress could not have intended the AMT to apply in the taxpayer's case where the amount of AGI was so low. The court sympathized with the taxpayer's plight and the unfairness of the application of AMT in this case but held that the AMT was applied as required by I.R.C. § 55 and could not be changed by court order. Editor's note: the AMT exemption amount has been increased since 2000 but the AMT remains a consideration for many taxpayers, especially in households with more than one income. **Katz v. Comm'r, T.C. Memo. 2004-97**.

CAPITAL GAINS. The taxpayer and two other individuals won $9 million in a state lottery, payable in $360,000 annual installments over 25 years. The taxpayers and other winners formed a trust and assigned their interests in the lottery installments to the trust. The trust was required to distribute all income within five days after receiving an annual installment. More than two years later, the taxpayer sold the taxpayer's interest in the trust to a company for a lump sum payment. The taxpayer obtained a state court ruling that the assignment of the interest in the trust was allowed. The taxpayer reported the sale on Schedule D as a long-term capital gain. The IRS issued an assessment based on recharacterizing the sale as ordinary income. The court held that the structuring of the transaction as a sale of an interest in a trust would be disregarded and that the character of the lottery winnings as ordinary income could not be changed by the creation of a trust to receive the lottery payments. **Clopton v. Comm'r, T.C. Memo. 2004-95**.

COOPERATIVES. The taxpayer was an agricultural supply and marketing cooperative. The cooperative had distributed its patronage-sourced income to members as dividends in the form of common stock, associate member common stock and capital credits. Most of the dividends were issued as qualified written notices of allocation which were still outstanding. The cooperative suffered financial losses and filed for liquidation in bankruptcy. As part of the liquidation plan, no distributions were to be made to stockholders, including those holding stock distributed as patronage-source dividends, but the stock was not cancelled. All of the cooperative's assets were distributed to creditors, who received less than their claims. The general rule is that, if a cooperative cancels or redeems at a discount stock distributed to a member as a patronage-sourced dividend, the cooperative receives taxable income from the cancellation or redemption to the extent of the value of the stock or discount. The IRS ruled that, because the cooperative's stock was not cancelled or redeemed, no income was realized by the cooperative from the bankruptcy. The letter ruling does not discuss I.R.C. § 108 rules for discharge of indebtedness and the exceptions thereto. **Ltr. Rul. 200414019, Dec. 15, 2003)**.

CORPORATIONS.

EMPLOYEE. See cases under **S CORPORATIONS** below.

COURT AWARDS AND SETTLEMENTS. The taxpayer had filed suit against an employer for wrongful termination. The taxpayer signed a contingency fee agreement with the taxpayer's lawyers, who received one-third of the initial judgment and an hourly rate for the appeal. The taxpayer excluded the amount paid to the lawyers under the contingency fee agreement. The District Court acknowledged a split in authority on this issue and a lack of authority from the Second Circuit Court of Appeals. The District Court held that the contingency fee payment was not included in the taxpayer's income because the fee was never a personal obligation of the taxpayer nor was that portion of the judgment ever in the control of the taxpayer. The District Court focused on the taxpayer's rights to the money at the time the contingency fee agreement was executed and noted that the taxpayer had no right to the money at that time. On appeal the Second Circuit reversed, holding that Vermont law did not create a property interest in the lawsuit recovery for the attorney's contingent fee; therefore, the attorney fee portion of the settlement was included in the taxpayer's income. On remand, in accordance with the appellate decision, the trial court granted summary judgment for the IRS. **Raymond v. United States, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,215 (D. Vt. 2004), *on rem. from*, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,124 (2d Cir. 2004), *rev'g and rem'g*, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,196 (D. Vt. 2002)**.

MOVING EXPENSES. The taxpayers, husband and wife, had immigrated to the United States in 1998 and incurred air travel and other moving expenses. However, the taxpayers claimed their moving expenses as a deduction on their income tax return for 1999. The taxpayers provided no evidence of moving expenses incurred in 1999 and the court held that the 1999 moving expense deduction was denied. **Bajramovic v. Comm'r, T.C. Memo. 2004-96**.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, each owned a corporation which operated a business. The corporations rented office space in the taxpayers' residence. The taxpayers also had passive income from other rental properties but those properties had net operating losses. The taxpayers offset the losses against the rental income from the office space lease. The IRS recharacterized, under Treas. Reg. § 1.469-2(f)(6), the office rent as nonpassive because the taxpayers materially participated in the business activities of the lessees. Thus, the office rent income was ineligible for offset against the other rental losses. The taxpayers argued that the recharacterization rule was invalid as contrary to the passive activity rules. The court pointed to several Tax Court and appellate cases which have upheld the recharacterization rules. The taxpayers also argued that the recharacterization improperly negated their bona fide business purpose for renting the office to the corporations. The court noted that the statute and legislative history supported giving the IRS wide authority for determining which rental activities could be recharacterized and noted that neither the statute nor the regulations had any requirement that the lease agreement not be bona fide before recharacterization could be used. The court upheld the recharacterization of the rental income from the office as nonpassive activity income ineligible for offset against other passive activity income. **Cal Interiors, Inc. v. Comm'r, T.C. Memo. 2004-99**.

PENSION PLANS. On April 10, 2004, the President signed the Pension Funding Equity Act of 2004 which will replace, for two years, the 30-year Treasury bond rate used to calculate employers' contributions to pension plans with a long-term corporate bond rate; provide temporary relief from deficit reduction contributions; and provide relief to multiemployer plans. **Pub. L. No. 108-219 (H.R. 3108)**. The IRS has issued guidance on the new provisions in the 2004 Act. The revised 90-percent to 100-percent permissible range for plan years beginning in the months January 2004 through April 2004 is: January, 5.89 percent to 6.55 percent; February, 5.85 percent to 6.50 percent; March, 5.81 percent to 6.45 percent; and April, 5.76 percent to 6.40 percent. The notice also provides procedures for electing an alternative deficit reduction contribution under new I.R.C. § 412(l)(12), enacted by the 2004 Act. An employer is eligible to make the election if it is: (1) a commercial passenger airline, (2) primarily engaged in the production or manufacture of a steel mill product or the processing of iron ore pellets, or (3) a I.R.C. § 501(c)(5) organization that established a plan on June 30, 1955, to which I.R.C. § 412 now applies. The election, which must be made annually and cannot be made for more than two plan years for each plan, can be made for any plan year beginning after December 27, 2003, and before December 28, 2005. If an employer elects an alternative deficit reduction contribution for any plan year, the employer must provide written notice of the election to the plan's participants and beneficiaries and to the Pension Benefit Guaranty Corporation within 30 days of filing the election. **Notice 2004-34, I.R.B. 2004-34**.

S CORPORATIONS

BUILT-IN GAINS. The taxpayer corporation was originally a C corporation. The taxpayer elected S status in 1988 but revoked the election in 1989. The taxpayer re-elected S corporation status in 1994. When the second election was made, the taxpayer had built-in gains from years when the taxpayer was a C corporation. Under TRA 1986, a transition rule, allowing use of pre-1986 rules, applied to corporations which made an S corporation election prior to January 1, 1989. The taxpayer argued that the transition rule applied to its built-in gains because it had made an S corporation election prior to January 1, 1989. The Tax Court held that the transition rule applied only to the taxpayer's election which occurred before January 1, 1989. Because the taxpayer had revoked the 1988 election, only the 1994 election would be used to determine the appropriate built-in gains. The Tax Court held that the 1994 election was not eligible for the transition rule. The appellate court reversed, holding that the corporation was eligible for the transition rule because it had made an S corporation election prior to 1989 and the statute did not require the election to be in continuous effective before the built-in gain property was sold. However, because the 1994 S corporation election was made within three years of the sale of the property, the sale did not qualify for exclusion of the gain, even under the pre-1986 rules. **Colorado Gas Compression, Inc. v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,213 (10th Cir. 2004), *rev'g and rem'g*, 116 T.C. 1 (2001)**.

EMPLOYEE. The taxpayer was an S corporation wholly owned by one shareholder who also served as president of the taxpayer. The shareholder was an accountant and performed all the accounting services and business management for the taxpayer. The court held that the shareholder/president was an employee of the taxpayer and amounts paid to the shareholder were subject to employment taxes because the shareholder served as an officer of the taxpayer and performed substantial services for the taxpayer. **Joseph M. Grey Public Accountant, P.C. v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,214 (3d Cir. 2004), *aff'g*, 119 T.C. 121 (2002)**.

The taxpayer was an S corporation wholly owned by one shareholder who also served as president of the taxpayer. The taxpayer operated a trucking business. The shareholder solicited business for the company, handled its business transactions, managed its finances and performed the driving services rendered by the company for the taxpayer. The court held that the shareholder/president was an employee of the taxpayer and amounts paid to the shareholder were subject to employment taxes because the shareholder served as an officer of the taxpayer and performed substantial services for the taxpayer. **Mike J. Graham Trucking, Inc. v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,214 (3d Cir. 2004), *aff'g*, T.C. Memo. 2003-49.**

The taxpayer was an S corporation wholly owned by one shareholder who also served as president of the taxpayer. The taxpayer operated a water filtration and purification systems business. The shareholder performed all the services and business management for the taxpayer. The court held that the shareholder/president was an employee of the taxpayer and amounts paid to the shareholder were subject to employment taxes because the shareholder served as an officer of the taxpayer and performed substantial services for the taxpayer. **Water-Pure Systems, Inc. v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,214 (3d Cir. 2004), *aff'g*, T.C. Memo. 2003-53**.

LANDLORD AND TENANT

TERMINATION. The plaintiff had leased farm land from the defendant's parents for many years before entering into a similar lease for three years with the defendant. The lease contained a provision that the plaintiff would "well and faithfully till and farm the same in a good and farmer-like manner, according to the usual course of good husbandry." The defendant discovered that the plaintiff was allowing pheasant hunting for a fee on some of the land and that the plaintiff was not controlling Canadian thistle weed on the property. The defendant terminated the lease for failure to control weeds and to farm the land in a farmer-like manner. The trial court ruled for the plaintiff, holding that the lease did not prohibit the selling of hunting rights for a fee and that the failure to control thistle was part of the method to improve the hunting on the land. The appellate court reversed on this issue. The appellate court noted that Canadian thistle was a noxious weed in North Dakota and that North Dakota law and administrative regulations placed a duty on landowners to destroy noxious weeds. Therefore, the court held that the plaintiff's failure to control Canadian thistle was a breach of the lease provision to farm the land in a farmer-like manner. However, the plaintiff argued that the abrupt and summary termination of the lease was not the appropriate remedy. The trial court agreed with the plaintiff and the appellate court affirmed that ruling, noting that case law required a landlord to give notice of a breach and opportunity for the tenant to comply before terminating a lease. The plaintiff was awarded lost profits from farming the land. No damages were awarded from lost hunting fees because the plaintiff failed to present written records of the fees received. **Keller v. Bolding, No. 20030221 (N.D. April 13, 2004)**.

NEGLIGENCE

RESPONDEAT SUPERIOR. The plaintiffs were injured when their car struck a tractor owned by the defendant and parked on a highway. The plaintiffs sued the defendant owner for negligence and also sued a trust, arguing that the defendant tractor owner was working for the trust, either as employee or partner. The defendant tractor owner farmed the trust's land under a lease and was using the tractor at the time of the accident to conduct the defendant's own independent farming operations on non-trust land. The court held that the tractor owner was not an employee of the trust but was at best an independent contractor because the trust had no control over the farming operations of the tractor owner. The court also rejected the argument that the tractor owner was a partner with the trust, because the owner did not share any profits or expenses with the trust. The court characterized the relationship as more like a landlord and tenant. Thus, the trust could not be held responsible for any negligent acts of the tractor owner. **Coates v. Anderson, 84 P.3d 953 (Wyo. 2004)**.

STATE REGULATION OF AGRICULTURE

PESTICIDES. The plaintiffs were beekeepers who placed beehives in several counties in Minnesota. One defendant, the Minnesota Department of Natural Resources (DNR), established a program of raising hybrid poplars for conservation and biomass fuel. The poplar stands became infested with cottonwood leaf beetles and the DNR began a program of spraying the groves with Sevin. Although the Sevin label cautioned against spraying while bees were present, the DNR interpreted the label as allowing spraying unless significant bees were actively foraging near the groves. The plaintiffs claimed that the Sevin was killing large quantities of its bees and sued the DNR for trespass, nuisance, common-law negligence, and negligence per se, seeking an injunction, damages, and attorney fees. The plaintiffs argued that the DNR was negligent per se because the DNR misused the Sevin by failing to comply with the label directions for use. The plaintiffs argued that the label prohibited spraying of Sevin when bees were present in any number. The court, however, agreed with the DNR interpretation, holding that the DNR's interpretation was entitled to deference because of the DNR role in enforcing pesticide application in Minnesota. The court also upheld a summary judgment for the DNR on the negligence and nuisance claims, holding that the DNR did not intend to harm the bees and applied the Sevin in accordance with the label. **Anderson v. State of Minnesota, 674 N.W.2d 748 (Minn. Ct. App. 2004)**.

WETLANDS. The plaintiffs, husband and wife, purchased 25 acres of rural land, most of which was used by the previous owners and the plaintiffs to graze horses. The plaintiffs started to clear trees and vegetation from an approximately 10,000 square foot corner of the property. The county issued a cease and desist order under a county ordinance because the area was a wetland. The plaintiffs argued that the area was exempt as agricultural but the county argued that the exemption did not apply because the area was idle for more than five years. The trial court ruled for the plaintiffs because the county had failed to verify that the land was a wetland but the court gave the county reasonable time to verify the land's character. On appeal the plaintiffs argued that the term "area" in the ordinance was void for vagueness. The court held that the term "area" refers to less than a whole property and was properly applied to a portion of the plaintiff's land which had wetland characteristics. The plaintiffs also argued that the agricultural use exemption applied to the selected area because the whole property was used for an agricultural purpose. The court noted that the evidence was not substantial that the area at issue was used by the plaintiffs or the previous owners during the five years before the cease and desist order; therefore, the court upheld the county's ruling that the area at issue was idle for the five years before the order. **Young v. Pierce County, 84 P.3d 927 (Wash. Ct. App. 2004)**.

IN THE NEWS

GENETICALLY MODIFIED ORGANISMS. The Vermont House of Representatives has passed the Farmer's Right-to-Know Seed Labeling Bill which defines genetically engineered (GE) seeds as different from conventional seeds in the Vermont seed statute, and mandates the labeling of all genetically engineered seeds sold in the state. The bill must still receive final approval by the Vermont Senate. Responsibility for this labeling rests with seed manufacturers, not Vermont retailers, unless the retailers package and market their own GE seeds. The bill also requires seed manufacturers to report on GE seed sales to the Agency of Agriculture in addition to general seed sales reporting. **H-777. CropChoice News (April 12, 2004)**.

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